‘Your Cheque is in the Post’

A Discussion paper regarding Payment Issues in the UK Subsidence Industry

The Subsidence Forum 2006

Executive Summary

Until recently, the timeliness and effectiveness of the payment process in the subsidence industry has not been challenged. However, as suppliers become more discerning in their choice of client, as a direct impact of the present construction boom which will continue for most of the next decade, payments issues become more critical.

A detailed analysis of the cost of the problem does not exist. However assessment of the direct and indirect costs of the current payments process against a backdrop of external subsidence claims expenditure of £500m. (with all its inadequacies) indicates cost as much as £15m pa, or 3% of the total.

The paper suggests that good payment terms and increased capacity in the subsidence marketplace go hand in hand.

Poor payment terms coupled with reduced margins will reduce the supply base, reducing competition and further increasing claims costs (against a background of already increasing cost due to the construction boom).

The paper looks at some of the payment issues along the entire supply chain, and recommends a series of short term and medium term proposals for improvement.

Importantly this is not an attempt simply to improve the position of contractors in the supply chain. Whilst in essence there is nothing wrong with this, the theme of the 'poor old contractor' not getting paid is not central to this paper, rather that there is a need to match 21st century processes with 21st century payment systems.

Introduction

Poor payment has traditionally been an issue for the subsidence industry, but one which has not risen to the surface. This is not to say that that payment processes have been satisfactory or indeed payment being made in a timely manner - simply that it has not featured openly or discussed openly as a problem area.

The fact remains that payment problems have been with the subsidence industry almost for as long as the peril came into existence in the mid 1970’s, over 30 years ago. Those with longer industry experience will remember the demand of insurers to be provided with full interim and payment reports before releasing funds. These funds would be made either directly to the insured, to a repairer or to an adjuster under a mandate. Whichever option was adopted, a paper chase inevitably occurred.

This paper chase would usually initially show itself in complaint calls to the adjuster, then leading to occasional intimidation of the policyholder. This threat by contractors tends to become more prominent as they vent their frustration at not being able to get payments released in a timely manner.

In many cases slow payment to a repairer would result in a last minute faxed reports to the claims office, coupled with the famous promise ‘the cheque is in the post’. In the most extreme cases, the strength of the relationship between the adjuster and insurer was such that an insurer would make a payment based on a verbal request, to be backed up on paper at a later date.

Thirty years ago, the industry was heavily fragmented; nowadays it operates in an entirely different way, through delegated authority arrangements with suppliers, framework or term contract agreements, service level agreements (SLA's) and the advent of supply management techniques. But for all these changes, the payment process fundamentally remained as it was 30 years ago.

This report on behalf of the Subsidence Forum as a whole has been created against a backdrop of a different construction environment which places even greater focus on the need for better payment systems. The construction market is more buoyant than existed before in the history of subsidence. The approaching 2012 Olympics, Thames Gateway development and general building boom increasingly lead to suppliers being more discerning as to who they work for.

Payment terms are becoming as important as profit margins. Repairers were prepared to tolerate poor payment terms provided the work was adequately profitable, but that profitability has evaporated with the advent of supply management techniques, greater transparency and the leveraging of commercial relationships to create claims cost savings. Profit margins in the insurance sector have been reduced by the professional procurement of services, but also go hand in hand with prompt payments terms - which have not always been delivered as promised.

When coupled with poor profitability, against a background of other more profitable, less onerous repair sectors such as public sector regeneration, the problem of late payment becomes a real disincentive for the supplier base to work for insurers. This creates a problem for the present and also builds a problem for the future.

A Buoyant Construction Marketplace

The BCIS Construction Briefing in April 2006 concluded:

- Materials costs rose 2.1% in the year to 4th quarter 2005, yet nationally agreed wage rates rose by 5.4% in the same period.
- Materials prices are likely to rise at around the rate of inflation over the next year.
- Wage settlements are already expected to be agreed above the rate of inflation for 2006.
- New orders for construction rose by 6% in the 4th quarter of 2005, compared with the previous quarter, and 11% compared with the same quarter a year earlier.

These independent figures clearly indicate a buoyant construction market, confident in short term future workload, with a shortage of skilled labour driving increased construction costs. There is no likelihood of the position changing in the short or mid term future.

Payment in the Wider Construction Industry

Subsidence is simply an element of the construction industry which in itself is plagued with a poor payment record.

A similar survey by the National Association of Specialist Contractors confirmed that Construction Specialists Continue to Wait for Payment

- Half are paid up to 1 month late
- Third are paid extremely late (1 month plus)
- 70% say they are never paid on time

Domestic customers, local authorities and councils are reported to be the best payers

Larger or main contractors are considered the worst payers

- The smaller the company, the quicker the payment is received
- 22% of larger companies (t/o of over £5m wait for 60 days plus
- Compared with just 7% of smaller companies

However, the failures of the UK construction industry as a whole cannot justify inadequacies within the insurance sector. Two 'wrongs' never ever make a 'right'.

ASUC Survey

Albeit based on a relatively small survey sample, The Association of Specialist Underpinning Contractor (ASUC) undertook a survey of members. This indicated that the greatest payment issues arose where intermediaries – adjusters and project managers – were involved. (Appendix A)

It is important to recognise that this may not represent the industry as a whole and that others may have much more favourable experience of reimbursement.

Late Payment – how big is the problem?

To date, no independent assessment has ever been carried out to identify the direct and indirect cost of poor payments in the subsidence sector.

Some organisations mandate payments directly from insurers to contractors and, barring the very odd exception of 'human error' or where, for example, e-mails have gone astray etc, one of the biggest delay in certifying payments results from contractors presentation of unsubstantiated claims for additional works; poorly presented interim accounts, or the like.

Whilst this clearly does not apply to all, and many do a great job, it seems to be that contractors can very often be their own worst enemies when it comes to the certification and receipt of prompt payments. These, along with the important responsibilities of the contract administrator, are critical factors.

Supplier organisations are already considering best practice document for their members to ensure the contractors "do their bit" around agreeing valuations, variations and timing of interim applications.

In a world of "home workers" and call centres it is often difficult to have direct conversations with adjustor regarding variations and the like whilst work is in progress on site.

It is suggested that if the original specifications are more accurately prepared with a 10-15% contingency then the contractors could be within budget without recourse back to an adjustor – this of course requires confidence and adequate controls down the supply chain to allow contractors to spend the contingency within a set of given parameters.

Poor payment process appears not only to irritate but to add cost to the process. These costs fall into two distinct categories –

- the direct costs of managing the existing payment process,
- secondly the 'knock on effects' of suppliers choosing to work in other sectors as a direct result of poor payment.

Direct Costs from Poor Payment Process

The starting point is probably to consider the number of payment applications for subsidence related work in any given year, and the physical cost of this process.

Figures are uncertain, but if in a 'normal year ' of say 30,000 cases 50% are repudiated that leaves 15000 cases each with at least one maybe two payment reports. Taking the worst case scenario that equates to 30000 payments reports pa Assuming that each payment report takes 30 mins for the repairer to generate, 30 minutes for the adjuster to check and generate a report, and 15 mins to process by the insurer, over 37500 man hours per year are involved.

Assuming a fully loaded cost of say £50 ph, this equates to a cost of creating valuations and processing payments in the order of <u>£1.9m</u> pa

Of the 30000 cases there may be a particular problem with 1% requiring an additional resource of a further one hour making a further cost of <u>£1.5m</u>

Added to this is the cost of payment reconciliation issues – comprising the cost of sorting out whether a direct payment to a contractor has been made, or not. Again, figures are vague but across the industry a figure of <u>£1m pa</u> might not be considered unrealistic.

The total 'direct cost' of valuation generation and payment processing is of the order of <u>£ 4.4m</u>

<u>Indirect costs from Poor Payment Processes</u>

These falls into two categories –

- the cost of adverse cash flow, and
- the poor payment effect on encouraging suppliers to enter the subsidence industry.

Adverse cash flow.

Indirect costs relate to the cost of adverse cash flow. In any year, against industry spend of £500m, say 30% (£150m) of this is delayed beyond 30 days, to 90 or even 120 days. The aggregate cost of this to the supplier base in terms of overdraft facility may be as much as <u>£5m pa</u>

There is anecdotal evidence that some banks supporting contractors, who have traditionally granted overdraft facilities on the back of "safe" insurance funded works, are now beginning to change their opinion and advising their clients to withdraw from this market unless cash flow can be improved.

Disincentive to Enter the Sector

At a time of construction boom, suppliers are becoming more discerning as to who they adopt as clients. There is a clear pattern of suppliers exiting the subsidence market. Coupled with consolidation, the supply / demand imbalance is increasingly taking effect as the competitive environment reduces.

For example, engineering firms, builders and specialists are increasingly focused on new build. Exceptions naturally exist, namely those organisations which are locked into the industry with little chance of escape. However these 'locked in suppliers' do not constitute the majority of insurer expenditure, which rests with the building repairers themselves.

The advent of repairer networks whilst reducing supplier management costs may in some areas be actually adding cost to the process. The Office of Government and Commerce OGC asked the question in their publication 'Smaller supplier, Better Value'? It is beyond the scope of this report to debate supplier management issues but until the subsidence industry is able to attract new entrants through improved payment terms, the industry will need to depend on the present or perhaps even fewer incumbents.

Suffice it to say that with less choice, distortions in the supplier base and the lack of competition may be leading to increased repair costs of possibly as much as 1%, or £5m pa.

Even recognising the 'guesstimation' which has occurred in these calculations, a case can be argued for poor payment process directly and indirectly costing the subsidence industry in total as much as £15m per annum

Productivity and Prioritisation

At first sight it is easy to blame the insurer, intermediary or the individuals involved. However it is important to consider the causes, rather than the symptoms.

Productivity

The increasing effect of commoditisation within subsidence has directly lead to suppliers needing to operate at a high level of productivity, to meet

- the financial needs and demands of their ownership structure
- the need for profitability within limited remuneration rates
- to comply with client requirements to meet contracted service levels, even if this means inefficient working practices.

As a result, the individual workloads of intermediaries are at a high level, albeit this figure can be disguised by the breaking of the caseload into segments. This also may reflect on customer service, and the problem heightens when there is a surge of work – when existing resources 'stretch' to meet increased new losses (sometime at the risk of reducing attention on work in progress).

Prioritisation

At the same time, there appears to be an absence of requirement – either implied or contractual – to deal with payment issues in a timely manner.

As a result, payment issues do not receive full attention as they have low priority. In fact payments may only be deal with by the individual to avoid supplier complaint which has an even greater disruptive effect.

In an environment of service levels, there are few controls around the speed of the payment process mid claim. Where controls do exist, they are seldom adequately policed.

The Role of the Insurer

Under ICOB 7 for Retail customers, insurers are required to endeavour to make payments within 5 business days. For commercial customers it is within a reasonable period but most insurers try to adopt the 5 business days as a model. They get round this on the larger commercial cases by making electronic payments. Most large insurers have central payment teams for suppliers and there is no reason why they should not adopt the 5 business days model for them as they do so for customers.

There is no evidence that insurers deliberately withhold payment. Indeed most insurers simply see the payment process as just that – a 'process' within the overall claims system. (There is anecdotal evidence of one insurer imposing a delay of a month or more in making payment to third parties which seems to cause problems for other insurers and their suppliers such as solicitors and adjusters, but that in itself appears to be a deliberately managed matter and capable of change.)

For insurers, the fewer touches, the less work, the better for their operational effectiveness provided of course that adequate controls are in place to ensure that valuations are correctly stated and properly 'signed off'.

Insurers could however ensure as part of their procurement process that all parties in their supply chain have an adequate payment process in place and audit the efficiency of such a process.

E payments are being considered by insurers and are certainly more efficient. Suppliers can ask for such a facility in negotiating contracts. Some insurers comment that e-payment is perhaps no quicker than the cheque payment system - easier for the recipient but not perhaps any faster to issue by the insurer. (Perhaps electronic systems as they currently operate are not in fact the panacea.)

An increased move to delegated authorities can help the payment process provided that the insurer has a good payment team that is not over loaded.

No insurer trusts its adjuster or engineer enough to give direct access to their payments system but some do provide advance funds to adjusters to speed up the payments process. This may be a useful way forward which might be capable of further exploration.

Whilst the importance of cash flow to contractors is fully acknowledged, they are not alone in such problems. Commercial constraints are often presented by the business terms required by some insurers of their intermediaries and loss adjusters. Typically these include no interim fees payments on lengthy claims; performance related fee structures bordering on penalty terms; consolidated invoicing arrangements which then take additional lengthy time to pay; requirements for service providers to share insurers risks; and commercial arrangements based upon predicted volumes of business which then, for whatever reason, do not then materialise.

There can be no doubt that he who pays the piper calls the tune…but of course it is important to pay the piper in a timely manner.

The Intermediary as Fund Holder or Distributor

In some situations there is evidence of intermediaries acting as fund holders or distributor whereby insurers money is paid to the intermediary – perhaps under a mandate – and then passed on to the repairer.

Problems often occur.

- The intermediary may derive financial benefit from not passing money promptly onto the supplier who may feel in such a vulnerable position as not to be able to complain (but may withdraw future services).
- The intermediaries own systems may not exhibit adequate controls to ensure payment is promptly made

This is often seen to happen where the intermediary operates a network, receiving a commission for the management of that network. The intermediary may consider that the only sure way of obtaining the commission is through deduction 'at source'.

One member of the Subsidence Forum suggested the worse payers are contractors to sub contractors, and that they ought to lead by example!

The Role of the Supplier – Never at Fault?

There is a tendency for suppliers to think that the payment problem may entirely be of the insurers making, or their intermediary. This is not so.

- Incorrect references may result in cases being difficult to track. Poor valuations of work, perhaps presented on a speculative basis may be rejected.
- Requests for payments 'on account' for work not yet carried out (because of an anticipated delay in payment) may be unsustainable, apart from the fact that few construction trades elsewhere are actually paid for work they have yet to do.
- The suppliers own systems may be inadequate to ensure that payments received are properly recorded.
- Suppliers need to learn to follow the clearly defined payment systems required by supply chain teams and work with their principals.
- This situation is heightened when a payment is made with an incorrect or perhaps no reference, or for the incorrect amount (nett of the policy excess for example, or as a part payment against a larger sum).

Particular focus is likely to be placed on adjusters and intermediaries who particularly may need to work smarter. The subject of payment is gaining momentum and will become increasingly important in competitive tenders.

Adjusters increasingly need to show that they can reduce the life of the claim.

Lengthy, long outstanding claims cost more money and all insurers are keen to reduce costs!

<u>The Roll of the Subsidence Forum to Improve Matters</u>

At the end of the day, insurers are driving costs and performance but suppliers have a choice – to adapt, or to exit. Perhaps this paper might have alternatively been entitled '*If you can't stand the heat….'*

The issue here though is that for some suppliers, leaving the sector may not be an option i.e. subsidence specialist loss adjusters. For that reason, the Subsidence Forum seeks to improve the status quo rather than recommending an exit strategy to the disenchanted.

The reality of the situation must also be recognized in that every insurer is always going to drive the 'deal' which they believe delivers the maximum benefit to their customers and shareholders, and everybody else in the supply chain has the choice to participate or not, as they see fit, on the terms being offered.

There are simply 'market forces' at play here. Whilst the current construction boom might mean that things will have to be improved industry wide, this will only happen as and when the market dictates such changes as being beneficial. There is an obligation on the Forum at least to raise awareness.

It has been suggested that the payment problem relates more to the companies that are not actively involved with the Subsidence Forum rather than those that are. That is not to say that with the larger companies problems do occur from time to time - but in the main the larger companies seem to have systems to make payments promptly.

The challenge for the Forum as to how to influence those smaller companies that are failing is a real challenge and not one that the Forum recognizes it will be able to achieve in the short term, but one which is nevertheless possible.

<u>Change is Possible</u>

Against this backdrop, some observers may suggest that the process is so ingrained as to make change impossible. This is not accepted by the Forum.

Some 25 years ago, the process of 'retentions' was commonly a part of the subsidence process. (A retention is an amount of money held by the client against the discovery of defects)

Retentions are also a problem area for the general construction industry. In a survey by NSCC they report

- At any time, an estimated £680m is being held in retentions within the construction industry
  - 54% of respondents fail to recover 20% of their retentions
  - 10% fail to recover 80% of their retention
  - Despite the use of retentions to rectify defects, almost 80% of respondents are not required to return and rectify defects

Retentions are not commonly used in the subsidence industry, and have been increasingly replaced by defects insurance guarantees. The reasons for the movement away from retentions were principally that:

- Framework agreements between insurers and repairers placed a commercial obligation on the repairer to return and complete poor work
- The adjuster or intermediary had no desire to keep the file open and delay submitting a fee
- The insurer equally had no desire to keep the file open
- Payment of the retention to the policyholder to be passed on in 6 months was met with problems, in that the policyholder would often conveniently find defects which prevented the retention money being passed on.
- The repairer saw the release of the retention as being a 'bonus' – in that there was a low expectation of its release and profitability did not depend on it.

Although the reason for the removal of retentions is multiple and partly complex, and the practice of retentions remain in the wider construction market, this example gives hope to the fact that the current payment process is capable of modification.

21st Century Claims, 20th Century Payment Process

The past 5 years have seen an increasing trend of standardisation of the subsidence process, following the model of Egan and Latham (fig 1).

All the key targets for improvement have been met or exceeded, without compromising commercial advantage or diluting competition. Indeed success has gone to those firms which have been able to provide effective, compliant products at low cost, whilst at the same time differentiating themselves through adding value.

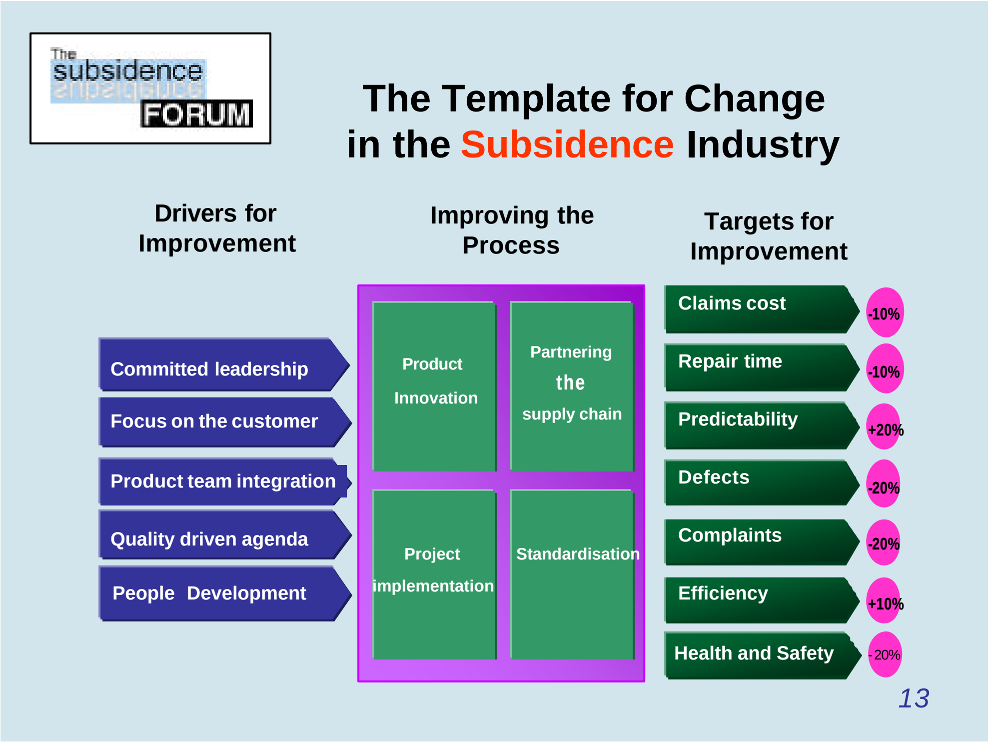

Fig 1

The Subsidence Forum support the sentiments of the NSCC Chairman, who said

> 'The timely movement of money through the supply chain is fundamental not only to enable specialists to invest and innovate, but in many cases to survive and for the client to enjoy the true benefits of integration'

> 'Good payment practices must become the norm and we must continue to address payment practices within our industry, if we are to increase investment in training, manage health and safety more effectively, and deliver quality products,

2007 brings two new features to the subsidence template (fig 2)

- Increased capacity in the market
- Better payment processes

The two elements go hand in hand in that as payment terms and processes improve, there is less likely to be losses of traders from the sector, in fact there may be new entrants. This healthy position will increase competition, controlling claims costs and driving up standards.

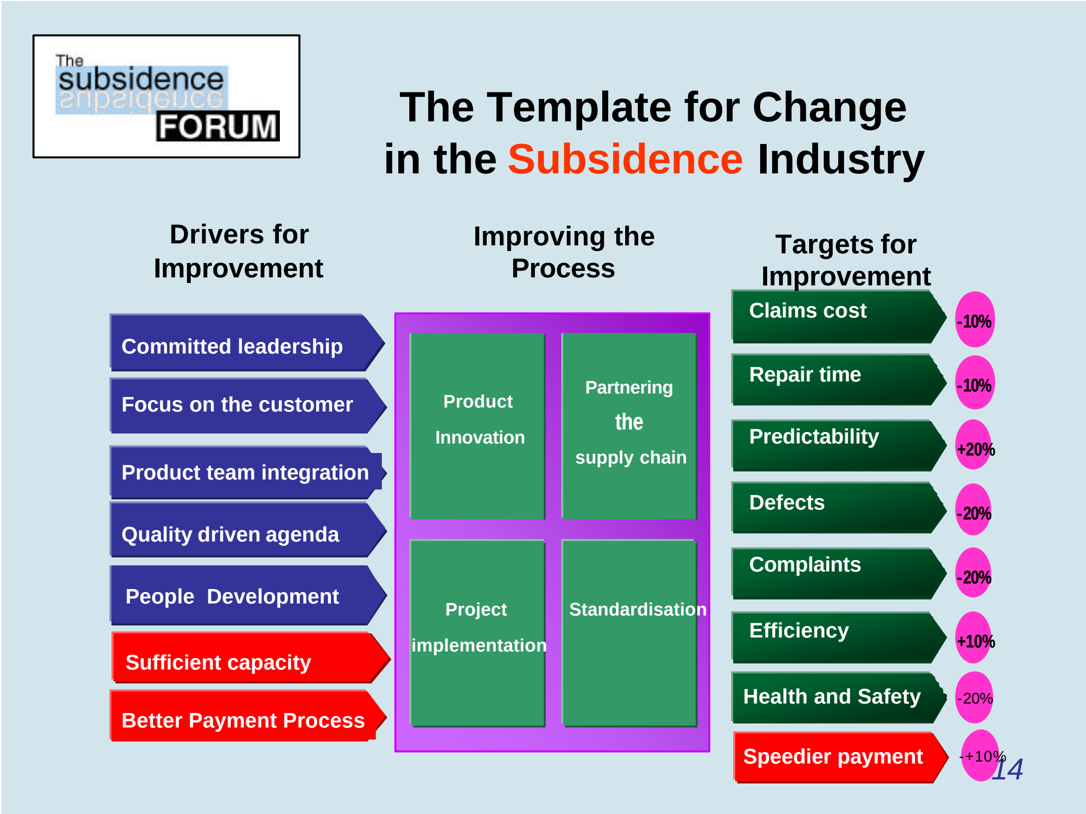

Fig 2

Next Steps

The Forum proposes a three stage process

- Raising of awareness not only of the issues but of the consequences
- Through the Forum's links with CILA and the Subsidence Special Interest Group there chairman has agreed to approach all loss adjustors for facts and figures regarding the payment issues covering
  - Numbers of claims
  - Repudiation rates
  - How many average payments per claim
  - Timescales adjustors work to regarding payments
- Better information on current payment issues, to allow improved understanding of the scale of the problem, and also to ensure that there is a benchmark against which to measure improvement
- A further report by the end of Quarter 3 2007 which proposes key action points including the results of the CILA survey above.

Interim Activities

1. Attention to detail; - It has been suggested that many of the problems rest in the simple things – poor or no references. Suppliers particularly are encouraged to pay attention to detail in that regard.
2. Documented payment processes; Organisations should as a matter of course have documented processes which identify the payment workflow. These should be up to date, and shared along the supply chain
3. Procurement documentation; Bid documents should make reference to payment processes, and use these in part as a measure of the evaluation of a suppliers suitability.
4. Audit processes; Internal and external audit should review compliance with payment service levels

Medium Term Activities

The direct and indirect cost of poor payments is indicated to cost the subsidence industry perhaps £15m, or 3% of total insurer spend in an average year, based on £500m total expenditure.

Increasing pressures on insurers will inevitably encourage them to look for improvements in effectiveness, part of which may come directly and indirectly from payment processes and terms of payment.

Increased and demonstrable progress in this area will encourage new entrants to the subsidence marketplace, improving sector capacity and competitiveness.

It is inevitable that future payment processes will be both standardised and electronically based, at least in part. Consideration should be given to the encouragement of innovation in this specific area, recognising that the cost benefit of slicker payment would substantially outweigh other areas of innovation interest.

Summary

Introducing modern payment processes into the subsidence arena is not going to be easy. It is a complicated and sensitive area; - after all we are considering a series of different services and supplier types, not widgets.

Pressures on insurers will continue to increase as we approach the end of the decade, and insurers will want to look carefully at all the options available to them. Claims departments which sometimes suffocate under paper driven systems may find E-invoicing a blessing, making the process easier to manage, and free people up to concentrate on strategic business areas such as service delivery and continuous improvement.

It is unlikely that e –invoicing will be developed in isolation, but rather be accompanied by electronic tendering, and electronic contract management. This will lead to secondary effects. The advent of 'electronic tendering' is likely to slash the cost of procurement, and the cost of handling numerous tenders and responses, which will in the future be more easily compared. The effect of this may be to reduce the duration of term contracts, or perhaps remove them entirely.

Electronic tendering will come hand in hand with electronic contract management - enhancing the management and performance monitoring of a larger number of suppliers. Information will be able to be accessed quickly, electronic audit trails will established and performance management will go through a step change of improvement. Inevitably some will be concerned that electronic invoicing, coupled with electronic tendering and contract management will damage the quality of services, but this is not the experience of the public sector and of those organisations which have successfully challenged the status quo (such as Kent County Council.)

But if the future of payment processes rests in electronic systems, at present no insurers or suppliers in the subsidence sector use such a method to its fullest extent. But interest is growing within procurement professionals who have successfully used such techniques in different sectors.

Now may be the time to start to explore how electronic systems can make the process simpler, and in doing so release valuable funds to improve the claims loss ratio. Future pressures on the residential insurance market will increasingly make a 3% saving in claims cost worth having – and squeezing the supplier is unlikely to be a viable strategy.

A 21st Century claims service requires a 21st Century payment process.

Appendix

CLIENT BASE		APPROX PAYMENT PERIOD (in days)			
		0-30	30-60	60-90	90+
1	Employed by Local Authorities	3	6		
2	Employed by home owners (non-insurance)	7	2		
3	Employed by main contractors (insurance related)		7	2	
4	Employed by main contractors (non-insurance)	1	8		
5	Where employed directly by Insurance Companies	1	2	2	2
6	Where employed by home owners who have a professional advisor acting for them i.e. Engineers or Surveyors with an intermediary Loss Adjusting Practice involved.	1	1	4	3
7	Where employed by Insurance Company appointed Project Managers		3	1.5	4.5

ASUC report 2007 – Payments in the Underpinning Sector